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U.S. Department of Transportation
Office of the Secretary of Transportation

GENERAL COUNSEL

400 Seventh St., S.W.
Washington, D.C. 20590

February 29, 2000

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Vernon A. Williams, Secretary
Surface Transportation Board
Suite 700
1925 K Street, N.W.
Washington, D.C. 20423-0001

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Re: Public Views on Major Rail Consolidations
Ex Parte No. 582

Dear Secretary Williams:

Pursuant to the Decision served January 24, 2000, enclosed herewith are the original and ten copies of the Statement of the U.S. Department of Transportation in the above-referenced proceeding. This Statement is also contained on the enclosed computer diskette, formatted for WordPerfect 5.1.

Respectfully submitted,

Paul Samuel Smith

Paul Samuel Smith
Senior Trial Attorney

Enclosures

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Before the
Surface Transportation Board
Washington, D.C.

PUBLIC VIEWS ON MAJOR RAIL CONSOLIDATIONS
Ex Parte No. 582

Statement of the United States Department of Transportation

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INTRODUCTION

As a result of several recent transactions and the proposed merger of the Burlington Northern Santa Fe ("BNSF") and Canadian National ("CN") railroads, the Surface Transportation Board ("Board" or "STB") has instituted this proceeding seeking comments from interested parties regarding the broader implications of a possible new round of major railroad consolidations and the evolving structure of the North American rail industry. The United States Department of Transportation ("DOT" or "Department") welcomes the opportunity to participate, and wishes to emphasize the importance of considering the industry within the context of overall intermodal transportation policy. Railroads are an integral part of the nation's transportation network; they are in fact partners, competitors, users, and providers with other modes and services in that system.

The Department accordingly agrees that it is the proper course, particularly at this juncture, to take the time to deliberate about where our national transportation system is headed as we move into the 21st century. DOT has expressly adopted this forward-looking perspective in developing our Mission Statement. We believe that it is our duty to ensure "a fast, safe, efficient, accessible and convenient transportation system that meets our vital national interests and enhances the quality of life of the American people, today and into the future." That foresight is required, we believe, to ensure that the government is the proper steward of the public interest, and it is equally relevant to what the Board should seek to accomplish here and in other proceedings. At DOT we have also developed five strategic goals that are our compass on matters affecting the nation's transportation systems. These goals are aimed at promoting and fostering safety, mobility, economic growth and trade, human and natural resources, and the national security. They are not modal in focus; they are, by their nature, intermodal and forward-looking. Clearly the issues raised in this proceeding, and discussed in more detail below, touch on every one of the five strategic goals that are the focus of DOT as we look toward the future of transportation in this country.

We at DOT have also, over the years, endeavored to take the time to specifically analyze where the nation's transportation system could be headed, and where it should be headed. In 1976, we produced a "Trends and Choices" study, which projected our best view of transportation concerns that would face this nation over the next 25 years. We are now working on updating this effort, attempting, again, to forecast where we would like to be in 2025. We believe that these are necessary projects; they are not only within DOT's obligation to pursue, but are the sorts of public interest inquiries that should be the focus of any agency that shares the responsibility of overseeing aspects of the national transportation system. We completely agree, therefore, on the forward-looking course the Board has set for itself in this proceeding. We believe that you can only deal effectively with present day transportation proposals and issues if you have a clear idea of where you want to be in the future.

DOT does not here express an opinion on the merits of the proposed BNSF/CN combination, or on any potential subsequent transactions. But given the fact that in the last twenty years the number of Class I railroads has declined from 26 to 7, and the prospect that there could ultimately be a national system of only two or three major carriers serving transcontinental and international routes, DOT fully supports the Board's decision to take this opportunity to re-examine its case-by-case approach towards Class I consolidations. In Ex Parte No. 575, the Department expressed the view that the significant changes in the rail industry since the Staggers Act called for review of the STB's guidelines and procedures on rate and access regulation, to determine if they met the needs of today's and tomorrow's shippers and railroads. We also urged a forward-looking perspective in our comments on the <u>UP/SP</u> merger. So too, in this proceeding, should the Board assess its traditional merger review criteria in light of the potential for major structural shifts in the rail industry.

Many, perhaps most, of the forces influencing these shifts, as well as the industry's reaction to these forces, are outside the scope of the Board's authority and influence. The body of DOT's statement contains a more detailed presentation on issues that have direct relevance in a merger review. Nevertheless, the STB needs to be fully informed about the existing state of the transportation industry as an integrated system, as well as potential changes, to determine if the current merger criteria are relevant to a 21st century U.S. economy. It must decide if the way in which mergers are approved will result in a financially viable rail industry that, in both the long and the short run, is more responsive to the needs of its shippers and more intermodal in nature than the system today.

DOT believes that a number of issues essential to the public interest must be addressed in considering the "downstream" effects of a BNSF/CN consolidation and others that it might precipitate. A primary concern of the Department with respect to further consolidations within the railroad industry is that we maintain safety throughout the rail network. When any further consolidation is proposed, therefore, the STB must consider the size of the resulting entity and insist that adequate planning and resources are in place to effectively address safety issues. As the size of a railroad and the scope of its operations expand, the possibility of safety shortfalls increases, and it is essential to ensure that corporate decision-making aimed at improving operational efficiency or financial returns do not in any way compromise safety. The public interest in a rail combination encompasses the safety of both the general public and of carrier employees.

As the trend continues toward further consolidation of the rail industry, the complexity of integrating respective labor forces also increases. The Department is concerned that the STB's authority to approve consolidations not be used to override existing bargaining agreements, and supports legislation and/or voluntary agreements between labor and management to eliminate "cram-down." We encourage the Board to defer such actions until such responses can be put in place.

As with other modes, the rail industry must have the ability to adapt to meet the evolving needs of its customers. For a railroad, that means substantially improving reliability and responsiveness for traffic with significantly different demands, from bulk chemicals to Pacific Rim imports and e-commerce shipments. Trains carrying just-in-time auto parts may need to meet a delivery window as narrow as a specific hour of the day, while coal destined to utility plants may only require a consistent transit time cycle of a week. In addition to the diverse requirements of freight shippers, railroads are also facing increasing calls for expanding commuter rail, to help cities ease congestion on highways and local roads, and expanded Amtrak operations. Yet we have seen traffic being redirected to the highways as a result of post-merger rail service failures. This only adds to congestion, loss of productivity, and detrimental environmental impacts.

Meeting these demands, and balancing often conflicting requirements, will be the test of the rail industry in the coming years. More mergers may indeed be part of the industry's response, but intra- and inter-modal marketing alliances or increased forms of cooperative operating practices could also be responsive to the future needs of the industry. With or without mergers, even current traffic levels require targeted capacity increases, to relieve physical bottlenecks. Meeting shipper needs will also require more improvements in information technology, to track shipments, interact with shippers and control operations.

Finding the funding for many of these capacity and efficiency-related investments may be difficult. Shippers, faced with the service deterioration following the Union Pacific/Southern Pacific and Conrail transactions, are justifiably opposed to rate increases when the prospect is that they will only bring operations back to pre-transaction levels. Railroads will have to work to convince their customers, and Wall Street, that the investments are critical not just to catch up, but to also improve service, operations, and profit. Public participation may be necessary where capacity is being expanded to provide beneficial returns to both the public and private sectors, as with the Alameda Corridor.

The question has been raised as to whether the time is now right for a renewed round of mergers, or whether the Nation's rail system would benefit from some breathing space. At the least, the Board should assess, in the context of past disruptions, whether proponents of a merger have shown both that their previous consolidations are functioning well, and that they are now demonstrably ready to undertake a new transaction without threat of service or safety disruptions. Additionally, the Board must be particularly mindful not to approve consolidations where the financial costs of the transaction would be so burdensome that system maintenance and improvements could suffer, both within the context of the merged company and for others that could be called upon to provide relief services.

The Board also needs to be cognizant of the interrelationships of the rail system with the rest of the Nation's transportation network, particularly its ports. Rail service between our major ports and inland markets is critical in sustaining U.S. trade flows. Moreover, the quality and quantity of rail service is an important element in the ability of ports to attract water carriers. Foreign control of railroads operating in the U.S. could lead to traffic shifts based on non-economic reasons (e.g., pressure to divert cargo to ports in Canada or Mexico, based on national interest rather than efficiency of operations). Such changes could have significant adverse financial impacts on U.S. ports and waterway systems. Additionally, a rail system comprised of larger and fewer Class I carriers can directly affect ports, rivers and Great Lakes commerce, trucking and defense shipments. Preservation of the existing rail infrastructure is critical in responding to the growing freight transportation market. In addition to the carriage of traditional rail bulk commodities, our nation's railroads have demonstrated success in servicing new traffic, such as intermodal, as well as automobiles and automobile parts. As congestion grows on our nation's highways, the rail infrastructure provides an essential alternative to transport freight economically and efficiently. That infrastructure must be preserved throughout the nation, and thus the Board must consider the implications of major consolidations on the operational and financial resources of individual applicant railroads and of the industry at large.

Although the Department is fully aware of a carrier's obligation to develop its own business, reaching new markets, and reducing costs through streamlining of operations or realizing economies of scale, individual carrier benefits from a combination cannot subvert the public interest. Ever-larger combinations among already large railroads could pose ever-larger uncertainties - - for shippers, other railroads, communities, railroad employees, and for the government itself. We outline some of those uncertainties below and discuss how they present risks. When those uncertainties involve public risks, as they do in the case of major railroad consolidations, and not just private risks to shareholder investments, then the public interest requires that a transaction's public risks be weighed against its public benefits. DOT therefore urges the Board to be open to the comments filed in this proceeding, and to invite interested parties in the BNSF/CN proceeding and in any subsequent consolidation cases to address uncertainties and examine public benefits both from the historical one-case-at-a-time perspective and, more broadly, in light of the evolving structure of the nation's major Class I railroads. Consolidations that generate public uncertainties that cannot be confidently dismissed from either perspective must offer greater public benefits in order for the balance to favor a determination that approval is "consistent with the public interest."

Starting now, therefore, there is a critical need to ensure that the public benefits of proposed major consolidations clearly outweigh the risks posed by the uncertainties that such transactions may produce both within the context of each transaction and within the context of the national freight transportation system as a whole. This requires the Board to broadly identify the public benefits in each case and to insist that, if approval is to follow, the level of these benefits must outweigh any increased detriments and uncertainties. Only in this fashion can future Class I combinations be adjudged "consistent with the public interest." In some cases, this will require that the Board maintain jurisdiction over transactions in the event that modifications are needed to accommodate the public interest in the light of future consolidations.

THE BOARD SHOULD RECONSIDER ITS APPROACH TO MERGERS

Rail consolidation proceedings have always logically required some forward-looking assessment, for the Board in these cases is attempting to review the likely public interest effects of a proposed -- not a completed -- transaction. In the past the Board's assessment has largely been restricted to the case at hand. But the circumstances in which future applications will come to the STB make a future perspective even more important than in the past.

The passage of the Staggers Rail Act of 1980 reduced government regulation and greatly assisted in the rationalization and revitalization of the railroad industry.

As carriers moved from the public utility mode to the private enterprise mode, part of that process has been the steady reduction in the number of Class I railroads or railroad systems. Precedent and policy combined during this time to ensure that each merger that was approved was conditioned in the manner necessary to maintain competition and essential services. The Department believes that the same statutory and policy requirements that made concern for competition the centerpiece of ICC/STB merger scrutiny now require a distinct recognition that additional concentration of the Class I railroad industry in the United States has implications that extend beyond competition. The scale on which these transactions are carried out also supports the need for a broader perspective. Should future consolidations proceed without adequate safeguards, it is very possible not only that large numbers of shippers could face non-competitive rates and services, but that many communities could endure environmental deterioration, and that other vital public interests could suffer.

We therefore believe that the Board's decision to consider the "cumulative impacts and crossover effects" of the BNSF/CN proposal is a good one. Indeed, it is incumbent upon the STB to reflect these changed circumstances. An agency "faced with new developments or in reconsideration of the relevant facts and its mandate, may alter its past interpretation and overturn past administrative rulings and practice." American Trucking Ass'ns v. Atchison Topeka & Santa Fe Ry, 387 U.S. 397, 416 (1967). *See also* Building & Construction Trades' Dept., AFL-CIO v. Donovan, 712 F.2d 611, 619 (D.C. Cir. 1983). Clearly a broader view is now required. We no longer have dozens of Class I railroads or railroad systems, and precedent and rules that were established when we did do not necessarily provide the proper guidance as the Board looks toward the future of rail transportation in this nation. In a similar context, the D.C. Circuit has held that when the legitimacy of past agency policy is called into question the agency "must always stand ready" to hear new argument and "to examine the basic propositions undergirding the policy." Bechtel v. FCC, 10 F.3d 875, 878 (D.C. Cir. 1993) *quoting* McLouth Steel Products Corp. v. Thomas, 838 F.2d 1317, 1321 (D.C. Cir. 1988). Such reconsideration is clearly warranted in circumstances where consolidation has reduced the number of U.S. Class I railroads to two Western roads and two Eastern roads. [1] The Department therefore urges the Board to weigh carefully the implications that its decision in this matter may have, not only on the immediate consequences of the proposed BNSF/CN combination, but also on the future composition of the railroad industry throughout the nation, and the resulting impact on the adequacy of transportation to the public.

1/ There are also four smaller Class I railroads in the Midwest: Kansas City Southern, Illinois Central and Grand Trunk Western (both owned by CN), and the Soo Line (owned by Canadian Pacific).

THE UNCERTAINTIES OF FURTHER CONSOLIDATION

The greatest uncertainties relative to future mergers would be presented in stark terms by the advent of a North American rail system dominated by two, or at best three, transcontinental carriers, operating across national borders. In fact, even short of this, the already heavily concentrated nature of the rail industry suggests that potential risks exist in every proposed major consolidation that the Board may now face. The existence today of only two major rail systems in the West and two in the East means that in each region competition among Class I carriers is already at its lowest denominator, and there is already no real margin for the partial or total failure of any one carrier. Any transaction that introduces significant uncertainty about the future of these carriers' continued competitive capabilities, or their individual abilities to survive, presents a risk to the underlying rail infrastructure that potentially could demand a costly response.

Within this general context, there are two major areas of concern that the Board must address in weighing the risks and offsetting benefits of future consolidations. The first, transitional in nature, pertains to issues and uncertainties associated with the finite but multi-year period that may be necessary for railroads to fully implement their own transactions. A series of mergers would likely introduce a rolling period of transitions and consequences. The second, long-term in nature, bears on the potential problems and uncertainties associated with a national industry structure of two or three major Class I railroads, and raises more permanent concerns.

Transition Uncertainties

As we have previously noted, the already concentrated status of the nation's railroad industry raises particular transitional concerns in the areas of safety and service. Because the potential consequences relating to these issues would be so far-reaching given the present industry structure, we believe it is prudent to stress the importance of proper identification of, and responses to, these uncertainties during the transition or implementation stage of an acquisition as well as in the long-term.

1. Safety

The first concern of the Department with respect to rail consolidations is to maintain a safe and viable railroad system that serves the nation's transportation needs. In recent years the Federal Railroad Administration ("FRA") has become increasingly concerned with the safety risks posed by the integration of huge carriers with different operating rules, information technology, dispatching standards and procedures, and safety philosophies. As the size of a carrier and the scope of its operations expand, careful planning and close communications with local operating units are essential to maintaining safety.

The STB, too, has been mindful of the capacity for broader consequences presented by the scale of recent rail industry consolidations. The largest railroad now in the U.S., the Union Pacific, suffered numerous post-merger accidents and incidents, at tragic cost and with significant impact on service. FRA reported to the Board its assessment of safety at the merged UP/SP as well as the combined BN/SF. DOT-3, filed October 21, 1997.

The significant safety issues that arose during the implementation of these mergers led to the requirement that consolidating Class I carriers develop, together with FRA, a Safety Integration Plan ("SIP") following FRA's guidelines, in order to ensure an acceptable level of safety during and after the integration of their operations. Through a Memorandum of Understanding with FRA, the Board also arranged for joint monitoring of the implementation of each SIP. 63 Fed. Reg. 72225 (December 31, 1998). It has been FRA's experience that the larger and more complex the merger, the greater the possibility of safety shortfalls. SIPs for any transcontinental combination would therefore doubtless be both comprehensive and detailed. Naturally, following the successful implementation of a consolidation, railroads must be required to continue to operate at the highest levels of safety.

An international component in a case, as with the BNSF/CN proposal or any proposal to link a U.S.-based carrier with a Canadian or Mexican railroad, introduces yet another uncertainty: the adequacy, consistency, and effectiveness of extra-territorial regulatory oversight. FRA has not previously attempted to exercise its safety authority, which is plenary in the U.S., over operations in other countries. There has been no basis to do so, for the implications of foreign operations for safety in the United States have been minimal. But the possibility of common control of thousands of miles of track in two or more countries potentially changes the situation radically. We have begun to grapple with the problems associated with dispatching trains in the U.S. from outside this country. Control, maintenance, record keeping, employee certification, place and level of decisionmaking, and a host of other aspects of commercial rail operations, present new legal and practical uncertainties when conducted from abroad. It must also be noted that there could be implications for the Nation's defense transportation network and rail infrastructure vulnerability in these situations, and therefore there is a need for careful consideration of the views of the Department of Defense whenever U.S. rail operations could be controlled outside the United States. These international differences, including regulatory disparity relating to safety matters, will have to be fully reconciled.

2. Service

The Department notes that the Board's remedial options in responding to the post-merger UP/SP service failure were even then very limited. Although line sales, directed service, and other alternatives might technically have been available, the STB recognized that none of these options was likely to resolve the crisis quickly. During the crisis, shippers and smaller carriers endured lengthy and costly delays while UP and other railroads attempted to rebuild and expand infrastructure and to add equipment and employees. As these carriers redirected equipment and resources from other parts of their systems and from other railroads, one observed a ripple effect of unprecedented proportions. Based on that experience, the Board must consider whether mergers of the scale now contemplated create uncertainty with respect to even larger service failures. There is also the very practical issue of the adequacy of the Board's resources to address such problems. Here again, the uncertainty of a proposal's impacts warrants increased attention to its prospective public benefits.

Long-Term Uncertainties

Following a period in which railroads have implemented their consolidations, we are left with a long-term outlook for an industry that, in ultimate form, may be comprised of two or three major transcontinental and potentially international Class I carriers. DOT believes that such a scenario presents issues raising the potential for long-term consequences, which are outlined below.

1. Competition

As the Board stated in its first order in the BN/CN proceeding, and as the chief executive officers of the other major Class I railroads have warned, approval of that combination could trigger a succession of additional "defensive" mergers in the industry. This may or may not happen, but the prospect certainly warrants attention. If it did occur, the few remaining such carriers could match up in a number of different configurations, virtually all of which would be classic "end-to-end" transactions that have traditionally presented few, if any, intramodal competitive problems. But the competitive questions presented in the present context are greater than those posed by any one merger in the abstract: they flow instead from the effects of a consolidation on a country, or continent, in which there would be only two or three giant railroads. Simply put, the potential for a national rail duopoly is the major competitive issue in assessing the future of the industry and its impact on the public interest. At that point each carrier would provide the only rail competition to the other. No other railroads would spur innovation and efficiency, or reasonable rates and responsive service for rail-dependent shippers. Intermodal competition, and product and geographic competition to some extent, could continue to prod railroads for the benefit of some shippers, but turning to motor carriage has its own costs – notably increased highway congestion and pollution, and the product and geographic alternatives are acknowledged as less effective forms of competition.

Economic theory teaches that the competitive outcome of a duopoly is indeterminate: the result could be either intense rivalry or comfortable accommodation, if not collusion, between the duopolists. The Board accepted this principle in its UP/SP and CN/IC decisions. Traditionally, the major concern has been with the latter, that the industry will not be sufficiently competitive. The antitrust laws are designed to cope with that concern, but it is uncertain whether the case-by-case implementation of those laws is well suited to maintaining the required level of competition in a large network industry, where local actions can have consequences for the entire rail system and where new entry costs are substantial if not prohibitive.

2. Consequences of failure

However, even if the outcome of a rail duopoly were to be intense competition, there are other uncertainties and risks to the public interest that must be assessed, including that of an unexpected and unintended national or regional monopoly due to the failure of any of the remaining railroad(s). More consolidations in the industry could result in carriers that are too big to manage, yet too big to fail.

If the North American rail industry were to evolve into two, or even three, major transcontinental railroads, this would introduce a particularly grave uncertainty in the event of the financial failure of any one of these roads: intervention by the federal government. Even if conditions could be imposed to ensure that the remaining railroads competed vigorously, over time one might fail to meet the competitive challenge of the other in one or more areas. Since the industry is marked by economies of scale, related to traffic densities, as the more successful railroad draws competitive traffic away from the less successful railroad, in certain lanes the former's costs may decrease, allowing it to acquire still more traffic from its less successful competitor.

Although the marketplace justly rewards the investment, marketing and operational skills required to become a successful competitor, in these circumstances that very success (*i.e.*, competition itself) might threaten the financial health of the less successful competitor. Declining market share could lead to reduced investment, withdrawal from markets, and a deterioration in service for shippers. The STB might be able to devise new standards that would require applicants to demonstrate their long-term post-consolidation financial viability. But without some assurance, the financial condition of the less successful railroad could deteriorate to the point that it could be forced to forgo needed capital investments or even be pushed into bankruptcy. This is obviously a worst-case scenario that might never occur. The consequences could be so severe, however, that this risk, the seeds of which are already in place as a result of prior transactions, should be weighed in the context of future consolidation proceedings. At a minimum, the STB should assess the financial exposure of both the private and public sectors should a proposed major consolidation fail.

The Department's concern with the prospect of federal intervention in the case of a failing rail carrier in these circumstances has a historical basis. As they did before the Staggers Act, shippers and communities faced with declining or uneconomic service may demand government intervention, including subsidies or even a take-over in a fashion reminiscent of Conrail, in order to assure continued service for industries deemed crucial to their economic survival. Canada earlier faced a similar problem when it was forced to support the CN, which was failing in competition with the Canadian Pacific. Today, each of the largest railroads in the U.S. controls a critical portion of the national transportation infrastructure. A termination of service by any of these systems would be unacceptable, since the impact would be debilitating within the region directly served by the railroad and would also extend beyond this to the national economy. Motor and water carriers as well as large regional railroads simply do not have the capacity to wholly replace any of the four major railroads. Not only would there be an adverse effect on transportation itself, such a failure would raise implications in the areas of increased air pollution and highway congestion, and this would also be contrary to the public interest in making the most efficient and effective use of the nation's transportation infrastructure. Major rail capacity reductions, in short, are simply not acceptable from the point of view of national transportation policy. Nor can we be comfortable about a future in which the federal government finds itself the guarantor of the survival of the remaining railroads.

3. Environmental and community impacts

Recent major mergers have been of a scale that required the preparation of extensive environmental assessments or an environmental impact statement. Shifts in railroad traffic among lines of the merged carriers with negative impacts on communities facing major increases in train operations has emerged as a substantial potential issue. (E.g., Reno and Wichita in the UP/SP case, and Cleveland and other points in Ohio in the Conrail Acquisition Case.) Indeed, resolution of these kinds of problems is one of the objectives of the Administration's "Livable Communities" initiative. Transcontinental mergers predictably could lead to similar or even larger traffic shifts that pose concomitant environmental concerns, requiring the Board to order even stronger and broader mitigation conditions.

4. Regional and short line railroads

Regional and short line railroads have grown significantly in the last twenty years; they now serve thousands of shippers. This segment of the industry, too, faces uncertainties from a final wave of mergers. For example, they may lose friendly connections. They have also suffered during post-merger service problems of the last few years. These can create significant traffic losses for the smaller roads; since many are financially frail, even revenue losses in the short run may result in failure and a loss of critical rail infrastructure. Such an outcome would have obvious negative consequences for the communities and shippers they serve. Unfortunately, the uncertainties come at a time when the capital requirements of these carriers are growing. There has also been substantial public investment in regional and short line railroads, which could be put in jeopardy. The needs of these carriers may conceivably be addressed were the Board to include them in a merger transaction, protect their access via conditions, or by other means. But absent such intervention, which is no longer typically exercised, effects on the financial viability of regional and short line railroads must be considered in allowing major transcontinental mergers. Weakening these railroads surely would have negative consequences for the communities and shippers they serve, both in terms of service and capacity.

5. Rail passenger carriage

As the Department has indicated in past merger proceedings, the STB must also be concerned about the effects on rail passenger carriage of continuing consolidations among Class I freight railroads. Amtrak has recently announced a significant increase in its proposed services, and the nation's commuter rail operators often seek as well to attract additional riders with new services. In many instances these passenger carriers use Class I track and other facilities, and thus have clear capacity needs. Even where they do not, both types of carriers must closely coordinate their services in the interests of safety and efficiency. The public interest in the long-term future of rail passenger service requires the Board to recognize and protect the legitimate interests of passenger transportation during the consideration of future industry consolidations.

6. Infrastructure impacts

The uncertain effects of transcontinental, and especially international, rail consolidations on other transportation modes, port infrastructure, and national defense interests must also be considered, both in the context of the present rail system and in the context of any ultimate system of two or three national railroads. Where international ownership is proposed, the Board should determine the potential for rail operating decisions to be made to further political or other non-economic national objectives, rather than service efficiencies. This is particularly important in examining the impact on critical U.S. port and waterway systems, which depend on rail service to move freight to and from distant inland markets.

Even without international considerations, continuing consolidations in the rail industry would undoubtedly affect other elements of the national transportation system, especially roadways and ports. This is to some extent an economic rationalization process that may cause some elements of the system (e.g., specific ports or trade lanes such as the Great Lakes-St. Lawrence Seaway system) to be used more and others to be used less. Nevertheless, in extreme cases, revenue losses associated with reduced traffic at, for example, individual ports could threaten their commercial viability and the cohesiveness of the maritime transportation system. Additionally, the "worst case" bankruptcy scenario cited above could have disastrous consequences for ports or waterway systems served by the failing railroad. This in turn could have repercussions on national security capabilities, since ports, railroads, and the air and land transportation infrastructure are an integral part of the Defense Transportation System. This potential secondary impact of further consolidations should be examined.

THE PUBLIC BENEFITS OF FURTHER CONSOLIDATION

Against these and perhaps other uncertainties posed by transcontinental consolidations, the STB must in each proceeding weigh the benefits of any proposed merger. We have already noted the likelihood that any Class I combinations that lie ahead will be end-to-end, and that such consolidations present few classical intramodal competitive problems. It is also true that in the past these transactions also have generally provided few quantifiable public benefits. A number of studies have concluded that economies of scale (saving in resource costs for society) that can be realized from end-to-end increases in railroad size are insignificant. Indeed, at least one study has found that as a railroad's network increases beyond a certain size, diseconomies of scale are introduced.

There are, of course, nonquantifiable benefits associated with end-to-end mergers, most importantly the extension of single line service. Such service, when it is well managed, is valued by shippers. In some cases, too, the possibility of shorter routes may be an advantage of end-to-end combinations (*e.g.*, in the UP/SP case), and even in end-to-end mergers there may be some elimination of overhead and staff reductions.

But the fact remains that end-to-end mergers offer limited public benefits as traditionally measured. The Department is concerned that these benefits may not, in all cases, outweigh the uncertainties that future transcontinental mergers may pose. Even those benefits that would clearly redound to the public, such as the shift of volumes of traffic from highway to railway, or from more- to less-congested railheads, have proven at times elusive to realize from more recent mergers.

THE UNCERTAINTIES ARE PROGRESSIVE

No one is in a position to know whether a single transaction will inexorably result in a series of consolidations ending in a transcontinental railroad duopoly. But neither are the uncertainties discussed above without substance simply because we are not now at that stage. There is a progression: as the size of railroads grows and the number shrinks, the uncertainties introduced by consolidations grow.

The merger of the UP and SP left only two major rail systems in the West. It was approved with the imposition of then-unparalleled conditions to replace lost competition and to mitigate environmental impacts. Oversight has been vigorous to ensure the efficacy of these conditions. Even then, UP's post-merger service breakdown was unprecedented, and wreaked widespread damage on shippers in the West and elsewhere. Post-merger accidents and incidents contributed heavily to the development of Safety Integration Plans in subsequent cases. The Conrail Acquisition Case left two major rail systems in the East. It was approved only after its extraordinary impacts on communities were addressed, and competition was preserved and even extended in the Northeast and elsewhere. We anticipate that oversight will again be vigilant. And again, unfortunately, the most detailed planning has not served to avoid serious service difficulties in large regions, particularly in the shared asset areas.

Moreover, past consolidations have led to others. UP contended that its union with SP was prompted, if not necessitated, by the need to compete with the then-newly formed BNSF. Although it had made efforts to acquire Conrail long ago, Norfolk Southern launched a new attempt only after CSX had announced an agreement to merge with Conrail. Whatever the motivation behind the current joint Class I railroad opposition to at least the timing of the BNSF/CN announcement, there is therefore some basis to think that the institution of Finance Docket No. 33842 may trigger other transactions. Since the U.S. now has just four major Class I rail systems, it is clear that increased attention to uncertainties and a concomitant insistence upon public benefits must begin now and continue as long as consolidations are under consideration.

The Department believes that, although any transaction must be analyzed with a careful eye to the future composition of the nation's overall transportation system, at the very least railroad mergers should not be approved in circumstances where the proponents of the merger have not yet eliminated the shift of volumes of traffic from highway to railway, or from more- to less-congested railheads, have proven at times elusive to realize from more recent mergers.

THE UNCERTAINTIES ARE PROGRESSIVE

No one is in a position to know whether a single transaction will inexorably result in a series of consolidations ending in a transcontinental railroad duopoly. But neither are the uncertainties discussed above without substance simply because we are not now at that stage. There is a progression: as the size of railroads grows and the number shrinks, the uncertainties introduced by consolidations grow.

The merger of the UP and SP left only two major rail systems in the West. It was approved with the imposition of then-unparalleled conditions to replace lost competition and to mitigate environmental impacts. Oversight has been vigorous to ensure the efficacy of these conditions. Even then, UP's post-merger service breakdown was unprecedented, and caused widespread disruption on shippers in the West and elsewhere. Post-merger accidents and incidents contributed heavily to the development of Safety Integration Plans in subsequent cases. The Conrail Acquisition Case left two major rail systems in the East. It was approved only after its extraordinary impacts on communities were addressed, and competition was preserved and even extended in the Northeast and elsewhere. We anticipate that oversight will again be vigilant. And again, unfortunately, the most detailed planning has not served to avoid serious service difficulties in large regions, particularly in the shared asset areas.

Moreover, past consolidations have led to others. UP contended that its union with SP was prompted, if not necessitated, by the need to compete with the then-newly formed BNSF. Although it had made efforts to acquire Conrail long ago, Norfolk Southern launched a new attempt only after CSX had announced an agreement to merge with Conrail. Whatever the motivation behind the current joint Class I railroad opposition to at least the timing of the BNSF/CN announcement, there is therefore some basis to think that the institution of Finance Docket No. 33842 may trigger other transactions. Since the U.S. now has just four major Class I rail systems, it is clear that increased attention to uncertainties and a concomitant insistence upon public benefits must begin now and continue as long as consolidations are under consideration.

The Department believes that, although any transaction must be analyzed with a careful eye to the future composition of the nation's overall transportation system, at the very least railroad mergers should not be approved in circumstances where the proponents of the merger have not yet eliminated significant disruptions from implementing past mergers. Stated affirmatively, the Board should require a showing that the proponents of a merger have overcome any past difficulties and have a specific plan for integrating their systems without further problems, were their transaction to be approved.

THE BOARD SHOULD BE OPEN TO INNOVATIVE CONDITIONS

As the number of railroad systems shrink, and the geographic reach of individual carriers expands, it may become more difficult for the STB to resolve competitive problems effectively through traditional merger conditions. The price for future consolidations in the rail industry may have to be the imposition of innovative remedies to preserve and even enhance intramodal competition. For example, in the CSX/NS acquisition of Conrail, the Board approved creation of a "shared asset" area, introducing two railroads into a region previously served by only one. Intramodal competition can also be introduced in bottleneck situations by requiring a carrier to offer rates to a junction with a second railroad. Not every situation calls for such drastic remedies (and the financial and cost consequences must not be ignored). However, the Board must remain open to non-traditional approaches.

The STB should also consider developing conditions that can be imposed in case of service failure, either short- or long-term. During the Union Pacific service breakdown in the West, the industry and the Board were caught by surprise as the problems continued to mount. In that situation, the Board, rightly, rejected the calls to impose conditions designed to increase competition to remedy what was purely a service-related failure. However, if it approves a merger in the future, the STB should be prepared to impose contingency plans to mitigate severe service problems, even if they are relatively short-term phenomena. While the Union Pacific's problems have largely been resolved, the costs of the short run failures -- to shippers, the UP itself and the rest of the industry -- were considerable.

CONCLUSION

The Department believes that ever-larger consolidations pose ever more significant uncertainties to the public. These uncertainties include service disruption, community impacts, regulatory questions, and safety and financial risks. All this must be balanced with the public benefits of each proposal as well as with an eye toward the perhaps not-too-distant future.

We appreciate that foretelling the future is a difficult task at best. But the risks we now face are potentially great, and we need to do all we can to ensure that our course is one that has been tested by analysis and by deliberation. Specifically, we believe that the public interest can only be served if we do all we can, at this juncture, to ensure that the 21st century transportation system that is now evolving is one that will serve the needs of the public in the areas of safety, mobility, economic growth and trade, human and natural resources, and the national security. This requires us all to be as forward-looking as possible.

Just as the Board has signaled its own intention to look toward the future in subsequent consolidation proceedings, we urge it to invite interested parties to develop approaches to address and analyze both the issues discussed above and those that may be just over the horizon. The risks of future rail concentration, both to the rail industry and to the national transportation system as a whole, demand that the Board adopt a forward-looking approach in all Class I consolidation proceedings, and that it have before it in those proceedings the best views of all concerned parties as to what lies ahead.